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SUBJECT: ESTONIAN GDP GROWTH SLOWS MORE THAN EXPECTED

¶1. (SBU) SUMMARY: A preliminary Estonian GDP growth figure showing only 0.4 percent growth in the first quarter of 2008 has shocked analysts and the public. Senior government economic advisors cite steeper-than-expected declines in consumer spending and a sluggish real estate market as the primary causes of the slowdown. While slowing growth has increased concerns that the Estonian economy faces a "hard landing," Estonian analysts stress the fundamentals of the economy are strong. A May IMF review concluded that Estonia's economic slowdown was necessary after two years of unsustainable growth, although the slowdown has been faster than expected and may result in overall negative GDP growth for 2008. End Summary.

Cautious Consumers Slowing Growth

¶2. (SBU) In mid May, the Estonian Statistics Office released a "flash estimate" for Estonian GDP growth at 0.4 percent for the first quarter of 2008, the lowest in eight years. As a comparison, growth in the fourth quarter of 2007 was 4.8 percent. While noting the growth estimate was based on preliminary figures, Aare Jarvan, Economic Advisor to the Prime Minister, acknowledged that growth this year has slowed faster than the GOE expected. (The Bank of Estonia's (BoE) forecast for 2008 was 2 percent growth. Other estimates predicted growth as high as 4-5 percent.) Jarvan cited the slowdown in consumer demand and a steeper-than-expected decline in the real estate market as the primary causes. According to BoE figures, this year real estate turnover has returned to 2004 levels and prices have decreased 10-15 percent from peak levels in 2007.

¶3. (SBU) Both Jarvan and Tanel Ross, head of the International Relations Department at the BoE blamed the decline in private consumption, in part, on higher than expected inflation. According to the Statistics Office, inflation in April was running at 11.4 percent. Rising energy costs, food prices and wages have contributed significantly to inflationary pressures. (Note: These factors not unique to Estonia. End Note.) Both Jarvan and Ross said they thought inflation in Estonia had now peaked and should begin to decline. However, Jarvan noted, the April figure was "a bit surprising" as the "direction was wrong."

¶4. (SBU) Despite the unexpectedly low estimate of first quarter growth, Ross noted, the BoE has not revised its GDP growth forecast for 2008. While the "risks have clearly increased," Estonia's economy has not "ground to a halt." Jarvan pointed out that unemployment in Estonia remains very low (about 4.2 percent) and wage growth is still strong (20 percent year-on-year.) The bottom line, he concluded, is there has not been a dramatic change in disposable income. Ross, however, cautioned that employment and wages are lagging indicators and he fully expects to see changes (i.e. downturns) there as well. He

also noted that while wage growth is still high, it is slower than in previous quarters. The combination of slower growth and steady employment levels signal declining productivity, which will be a longer-term concern for the Estonian economy. On the bright side, Ross said, initial data indicates that private sector wages have been more responsive to changing economic conditions than public sector wages. (Note: Over the past few years the GOE has significantly increased public sector wages including for police, medical, educational and rescue workers as well as white collar civil servants. Ross indicated that, as one measure of response to Estonia's slowing economy, he does not expect the GOE to implement any additional wage increases in the near term. End Note.)

¶5. (SBU) Experts here contend economic fundamentals remain strong and there are positive factors in the economy. Estonia's low debt and the government's commitment to maintaining a balanced budget are key. According to Ross, banks are still lending, although at a slower pace than in previous years and the BoE forecast of 13-15 percent credit growth is on target. While Banks are providing relatively less credit to households, they are lending more to manufacturers. Also, the quality of the banking sector's loan portfolio remains high. The share of non-performing loans (those overdue more than 60 days) is below one percent of the total. This is expected to increase slightly in the near term, but not to exceed 2 percent in
¶2008. Also positive, the Estonian current account deficit is decreasing steadily. Exports are outpacing imports (which have showed negative growth this year), and net savings have increased. The BoE expects the current account deficit to fall to around 10 percent of GDP this

year.

¶6. (SBU) According to Ross, the short- to medium- term health of the economy will depend on both domestic and external factors. Government spending is key; the GOE needs to keep outlays in line with economic growth. The GOE should not look to stimulate domestic demand. Rather, Ross advised, the GOE should keep macroeconomic policy neutral and allow some increase in unemployment to occur. Inflation is also important; the health of the economy will depend in part on how quickly inflation declines. The banking sector is another key factor. Scandinavian banks control approximately 95 percent of the Estonian banking sector. Continued health of these banks and their willingness to lend (e.g. no credit crunch) is crucial.

Then there's the Budget

¶7. (SBU) The GOE has demonstrated a consistent commitment to balanced budgets and continues to have the lowest government debt level in the EU. The GOE's budget has been in surplus since 2001. However, in April the GOE announced the need for a supplementary budget for 2008 to make up for an unexpected revenue shortfall. (Estimates on how big a shortfall the government faced ranged up to 3 percent of GDP). After negotiations within the Government coalition and among ministries, the Cabinet approved a supplementary budget which cut expenditures by 3.2 billion kroon (USD 320 million) and adjusted revenues down by 6.1 billion eek (610 million). On average, ministries and agencies cut their budgets by 7 percent - in line with the level recommended by the GOE at the start of the process, making the outcome a win for the government. The Ministry of Defense faced the smallest cut (0.8 percent) and the Ministry of Foreign Affairs absorbed the largest (14 percent). The Parliament began debating the budget proposal on June 4 and has committed to finish by the time of the June 18 recess.

¶8. (SBU) Jarvan told Pol/Econ Chief the GOE's original budget forecast had been "terribly wrong." The primary cause of the imbalance was lower than expected VAT receipts

- which make up about a third of central government income. (Personal income and social security taxes have been in line with expectations.) Jarvan commented that the changing structure of domestic demand has made a significant impact on VAT receipts: the two biggest areas of decline were sales of cars and real estate. Despite speculation in the press, Jarvan noted, the GOE does not plan to tap the Government's stabilization reserve fund or halt planned cuts in personal income tax rates. However, the three parties in the coalition have formed a working group to discuss priorities for the 2009 budget.

IMF Weighs In

¶9. (SBU) An IMF Mission in Estonia May 7-19 for regular Article IV Consultations provided its own assessment of the Estonian economy. Of note in the conclusions:

-- Estonia's economic slowdown was necessary after two years of unsustainable high growth, although the slowdown has been faster than expected and may result in overall negative GDP growth for 2008.

-- Inflation should moderate in 2009.

-- Although Estonia's current account deficit is shrinking it is still "larger than warranted" and needs to narrow further to improve Estonia's external competitiveness.

-- The GOE's quick response to the budget gap demonstrates its commitment to prudent fiscal management. The Government's proposal to freeze state wages should be extended to other levels of government.

-- The Government should adopt the draft labor law currently under discussion as it would go a long way to addressing labor market rigidities.

Decker